Gina Harrison
Director
Federal Regulatory Relations

1275 Pennsylvania Avenue, N.W. Suite 400
Washington, D.C. 20004
(202) 383-6423

PACIFIC TELESIS
Group-Washington

ORIGINAL

EX PARTE OR LATE FILED

June 19, 1995

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

RECEIVED

JUN 1 9 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Dear Mr. Caton:

Re: CC Docket 80-286, Amendment of Part 36 of The Commission's Rules And Establishment of a Joint Board; Docket 94-1, Price Cap Performance Review for Local Exchange Carriers

On June 15, 1995, Rex Mitchell, Regulatory Vice President, Pacific Bell, and I, met with Mark Uretsky, Chief Economist, Common Carrier Bureau; Kenneth P. Moran, Chief, Accounting and Audits Division; Kent R. Nilsson, Chief, Cost Analysis Branch, and Jonathan Reel, Andrew Mulitz, and George Johnson of the Accounting and Audits Division to discuss issues summarized in the attached materials. Please associate this material with the above-referenced proceedings.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

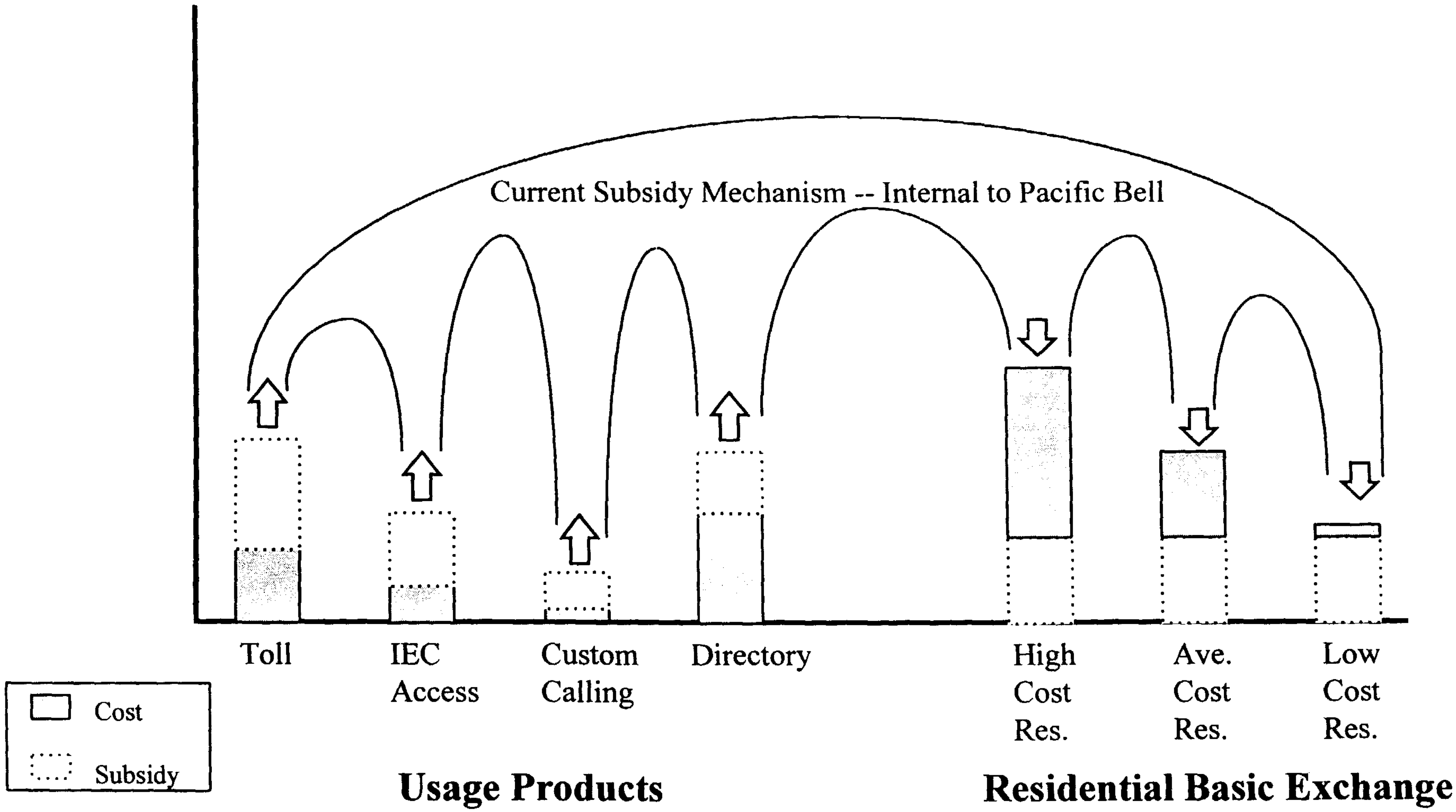
Sincerely,

Attachments

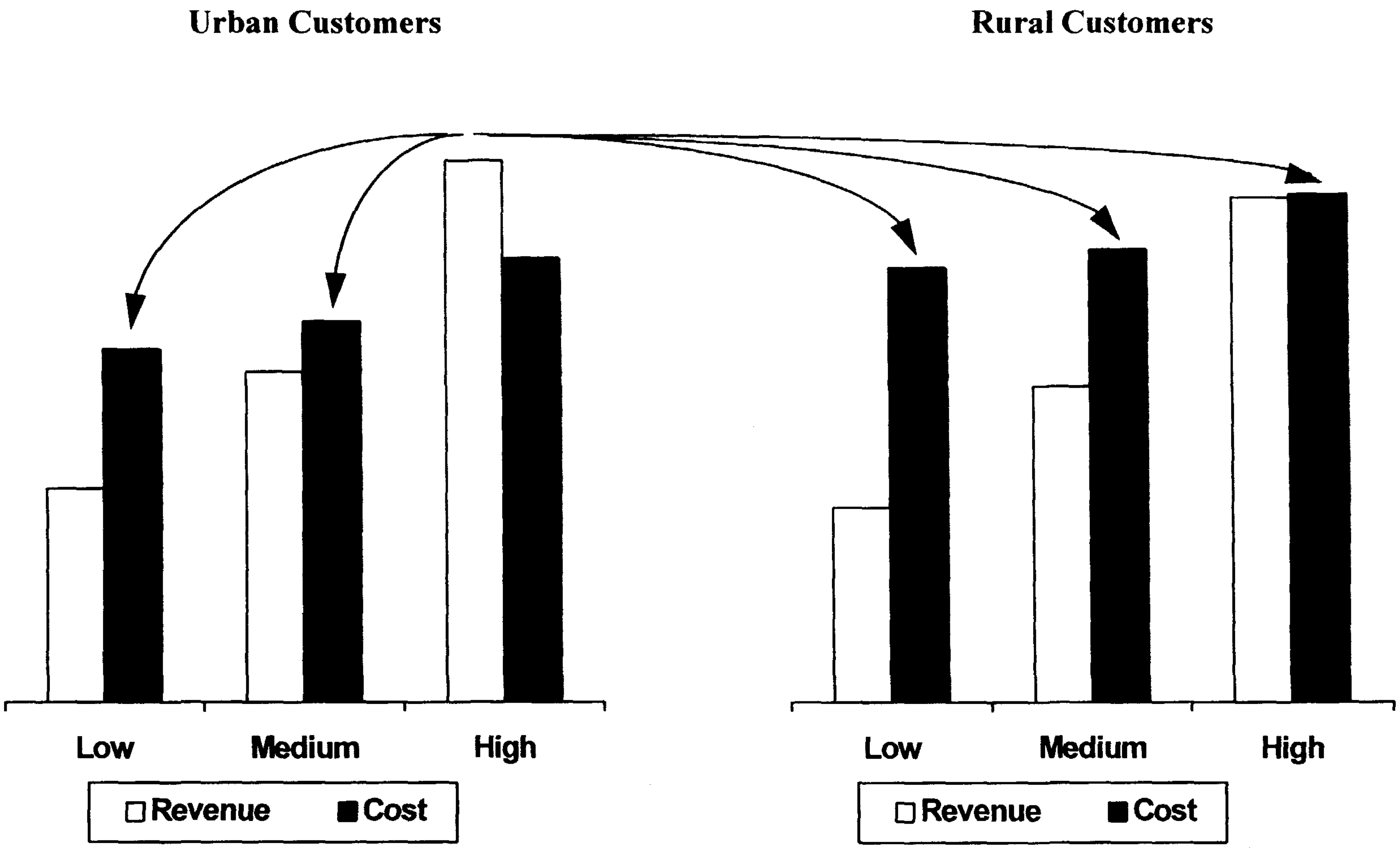
cc: George Johnson
Kenneth P. Moran
Andrew Mulitz
Kent R. Nilsson
Jonathan Reel
Mark Uretsky

Universal Service

Universal Service is Maintained Today by Subsidies Internal to Pacific Bell (and Other LECs)

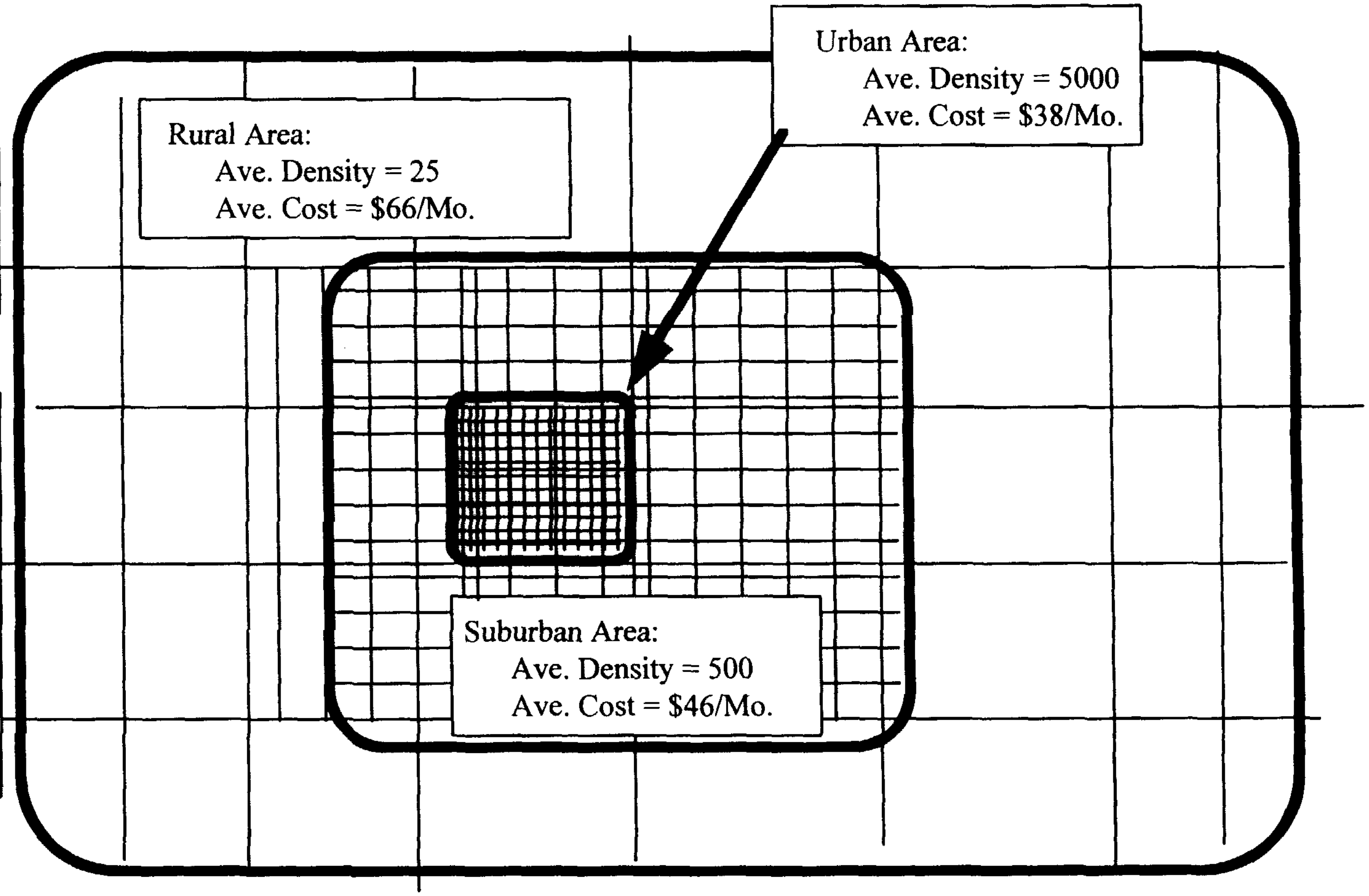


On a Customer to Customer Basis, the Subsidy Flows From Urban to Rural and High Use to Low Use



Subsidy Within the Exchange Area Can Ocurr Even Within a Rural Exchange

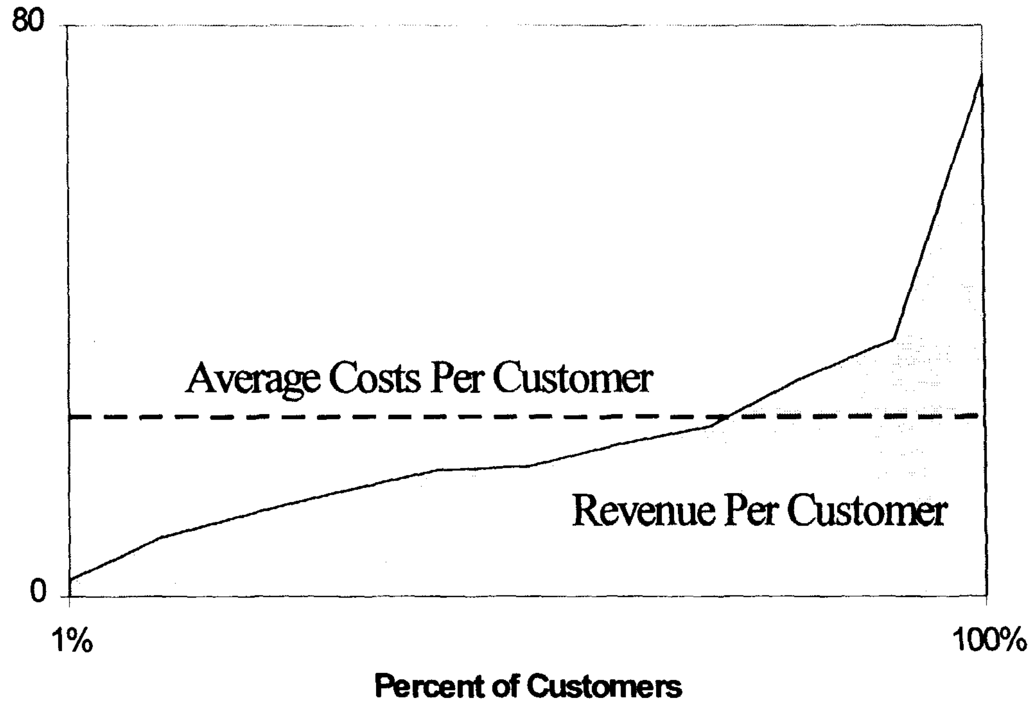
Entire Area:
Ave. Density = 950
Ave. Cost = $44/Mo.



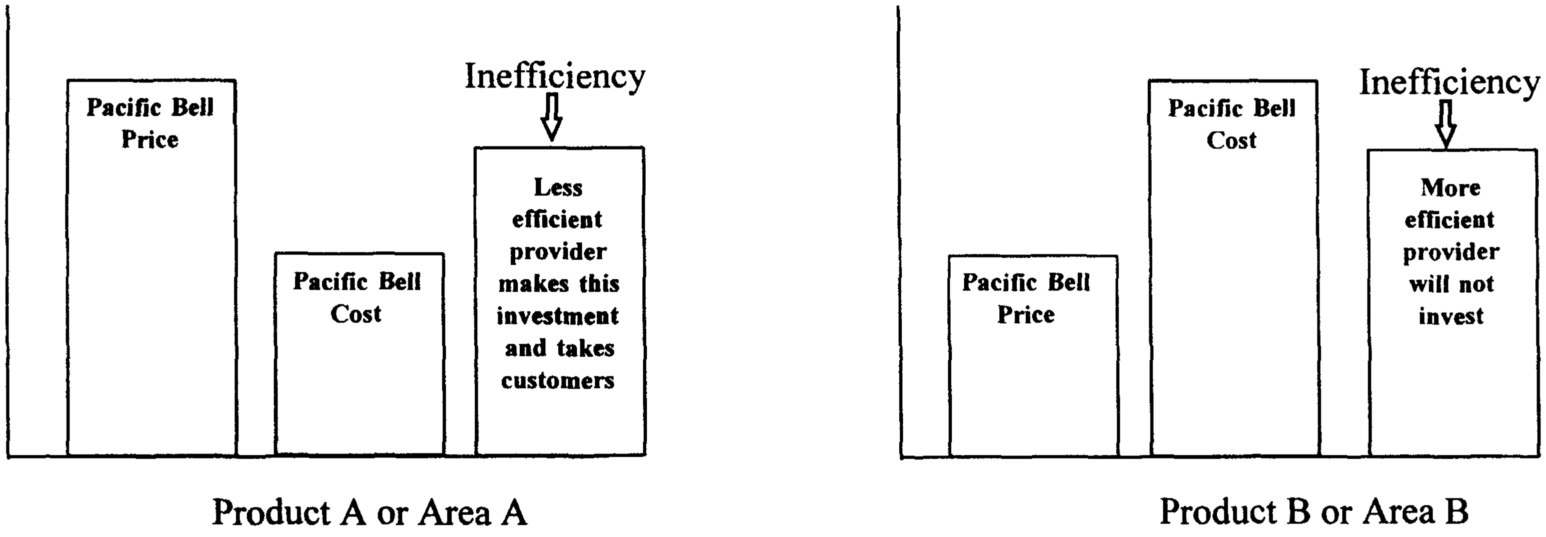
In this example, a Carrier of Last Resort that serves the entire area has a 15% cost disadvantage over the cream skimming carrier that serves only the urban area

A Very Small Number of Customers are Paying the Cost of a Very Large Body of Customers

- This is a very serious cream-skimming opportunity. California, has both extremes -- densely populated urban areas of San Francisco and the large expanses of a rural agricultural economy. Average rates of the incumbent provider will result in inefficiency in the marketplace.



The Economic Result is That a Less-Efficient Provider Could be Attracted to Invest While a More-Efficient Provider Could be Discouraged From Investing



The net result is inefficient investment. Already we see four providers of fiber networks overbuilding each other in dense metropolitan areas and no one clamoring to serve rural areas.

If Competition is Allowed Without Addressing the Subsidy Issues, Two Important Consequences Occur:

- No competition will develop where Pacific Bell prices are held artificially ***low***.
  - There will be no competition for rural customers, low use customers and high cost customers.
- Hyper-competition will develop where Pacific Bell prices are held artificially ***high***.
  - There will be extraordinary competition for toll and access, especially in dense areas.

This is Perhaps More True in California Than Elsewhere in the Country.

- Residential Rates are Low and IntraLATA Toll and InterLATA Access Provide a Huge Subsidy
- California has the Extremes of very densely populated cities and a large rural economy.

	Basic Rate (1FR)	Toll Revenue Per Line	State Access Revenue Per Line
California	$11.25	$112.00	40.00
New York	7.10*	22.00	31.00
Illinois	5.67*	14.70	12.40
Michigan	14.38	130.70	42.00

*Mandatory measured service for all residence customers.

The Subsidy Mechanism Worked Perfectly Well in a Closed System of a Single Monopoly Provider

- Important societal goals were achieved and economic distortions were minimized.
  - ***Important Social Goals***
    - Statewide averaged rates kept rural rates low.
    - Low residential basic exchange prices maximized penetration of telephone service.
  - ***Minimal Economic Distortion***
    - Large users could avoid subsidizing residential basic exchange services *only* by building private networks.

In a Competitive Environment, However, Public Policy Makers Must Either Abandon These Important Social Goals or Create a Universal Service Subsidy Mechanism That Works in A Competitive Environment. Any Other Condition Ignores Economic Reality.

- Rebalance rates
- Create a new subsidy mechanism
- Ignore problem and watch it grow larger and larger until major rate increases are the only alternative

There is a Viable Alternative to Rate Rebalancing or Total Loss of the Subsidy

- An external mechanism, applicable to all providers, that preserves existing subsidy flows could be implemented.
  - The customers of all providers of ***subsidizing*** services would contribute to the subsidy fund.
  - The customers of all providers of ***subsidized*** services would receive the benefit of subsidy funding.

Universal Service Alternative Plan

Universal Service Fund - Collection Mechanism

- The size of the fund would initially be determined based on incumbent LEC costs.
- The total amount of the fund shall be the difference between the revenue from residential basic exchange service as defined by policymakers and the incremental cost of such service, plus a reasonable contribution to shared and common costs.
- A surcharge will be imposed on the end-user telecommunications revenues of all certificated telecommunications companies to establish and maintain funding that is broadly-based and competitively-neutral.

Universal Service Fund - Distribution Mechanism

- The subsidy fund shall be distributed to local exchange carriers on a per-residential service address basis, for areas where the provider is certified as a carrier of last resort.
- Incumbents LECs shall reduce the price of exchange and toll services that are currently priced above costs, dollar-for-dollar, to offset anticipated fund payments.

Universal Service Alternative Plan

Universal Service Fund - Sizing the Subsidy

- A cost proxy model will be used to estimate the amount of subsidy per residential service address.
- The model will incorporate primary cost drivers such as population density, loop length, geological terrain characteristics (e.g., type and depth of bedrock) and street layouts.
- The subsidy level per residential service address will be calculated as the difference between the Commission-approved price and the proxy costs.

Universal Service Fund - Eligibility

- To be eligible to receive funds, the local exchange carrier agrees to be the carrier of last resort for residential and business subscribers within their serving area, using their own loop or loop-equivalent facilities.
- The local exchange provider must offer residential basic service as defined by policymakers at a price set by the Commission.
- All eligible fund recipients shall also meet Commission-established service quality and provisioning interval requirements.

Adoption of a Universal Service Funding Mechanism Preserves Important Commission Goals in a Manner Consistent with Local Competition

---

- Economic benefits -- competitors would invest where they are more efficient than Pacific Bell rather than where they are protected by artificially high Pacific Bell prices.
  - ➔ *leading to efficient deployment of societal resources*
- Societal benefits -- averaged prices and subsidy to residential customers would be preserved in a competitive environment.
  - ➔ *consumers would not be encouraged to change providers in order to avoid the subsidy*

Purpose of Visit

- Provide an update on recent activities in California
  - Interim Rules for Local Competition
  - Investment community's reaction to IntraLATA toll competition and Interim Rules
- Provide input on Universal Service
  - Existing Docket on Universal Service Fund

    (CC Docket No. 80-286)
  - The subsidy system internal to LEC rates
  - The necessity to eliminate existing internal subsidies by rate rebalancing or by creation of an explicit mechanism

The California Commission's Rulemaking on Local Exchange Competition

- CPUC goal is to open all markets to competition by January 1, 1997.
- In April, 1995, the CPUC issued proposed interim rules for local competition.
- The CPUC plans to adopt interim rules by June, 1995 and to allow immediate competitive entry shortly thereafter.
- The proposed interim rules provide many benefits to new competitive local exchange carriers (CLECs):
  - Minimal regulation similiar to non-dominant interexchange carriers.
  - Maximum pricing flexibility allowed by law.
  - Unlimited resale of incumbent LEC basic exchange services (e.g., no need to invest in any facilities to compete).
  - Flexibility to design calling rate areas different from existing California rate areas for local and toll calls.
  - May deny service to customers whose premises do not abut the CLEC's facilities.
  - Interconnection to incumbent LEC networks wherever the CLEC chooses.
  - Freedom to enter and exit at will as the incumbent LECs have sole carrier of last resort obligations everywhere.
  - No change to incumbent LEC regulation, pricing and market restrictions.

Investment Community Reaction to CPUC Actions

- The CPUC issued proposed interim rules for local exchange competition on April 26, 1995
- On May 1, 1995, Standard and Poor's placed Pacific Bell on CreditWatch, explaining that -- "The CPUC's proposed rules, if adopted in their current form, could lead to 'cream-skimming' and uneconomic competition....while Pacific Bell would continue to operate under current regulatory restrictions and prices."
- On May 4, 1995, Duff & Phelps downgraded Pacific Bell to 'AA-' (double-A-minus) explaining that "competitive pressures are mounting" while "it appears unlikely that the removal of cross-subsidies in PB's rates and its universal service obligations will be addressed before competition is accelerated".
- On May 16, 1995, Pacific Telesis stock price fell by $2.625 (or 8.9%) after the company projected that 1995 profit would be 10% below 1994 results.
  - Projected earnings decline attributed to the compounding effect of a 5% productivity factor, the lack of volume increases in toll calls as the result of lower toll prices and the adverse proposed interim rules for local competition.

Current USF Mechanism

- Pacific Bell does not receive funding from the USF because its rural areas are averaged into its urban areas by an internal subsidy mechanism
  - "Study Areas" are not the appropriate geography to determine funding recipients
    - They were not developed with universal service or
    - Use of Study Areas excludes the majority of rural high cost areas from universal service assistance
    - Rural high cost assistance should start from a definition of the areas that need subsidy
  - The base of payers needs to be expanded to include all telecommunications providers.

Universal Service and the Existence of Subsidy Must Be Addressed in Total

- The subsidies within Pacific Bell are significant
  - Product to product
  - Urban to rural geographies across products
  - Within each exchange area
- Subsidies when looked at on a customer basis reveal the economic harm
- Market distortion created by internal subsidy mechanisms
- California's unique situation
  - low residential rates
  - extremes of urban and rural areas
- A Solution
  - Explicit funding mechanism
  - Funded by all telecommunications providers
- An external funding mechanism preserves important societal goals